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SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1949

No. 574

PIEDMONT COTTON MILLS,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

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PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT.

Your petitioner, Piedmont Cotton Mills, prays that a writ of certiorari be issued to review the judgment of the United States Court of Appeals for the Fifth Circuit, entered in the above-entitled cause on October 12, 1949.

Opinions Below

The memorandum opinion of the Tax Court of the United States (R. 23-29) is unreported. The opinion of the Court of Appeals for the Fifth Circuit (R. 39-40), review of which is sought here, is reported at 177 F. 2d 148.

Jurisdiction

The judgment of the Court of Appeals for the Fifth Circuit, affirming the decision of the Tax Court, was entered on October 12, 1949 (R. 40). The jurisdiction of this Court

is invoked under Title 28, United States Code, Section 1254(1) (1948).

Question Presented

Whether, in determining, under Section 113(b)(1)(B) of the Revenue Act of 1936, the adjusted basis of property for the allowance of depreciation, a taxpayer must reduce his original basis by depreciation figures shown on his income tax returns for earlier years to the extent that such figures were in error and in excess of the amount allowable at the time the earlier returns were filed in the light of the facts reasonably known to exist at the end of each such taxable year, and where the errors had no effect on taxes.[1]

Statute Involved

Revenue Act of 1936: §§ 23(1), 23(n), 114(a), 113(b)(1)(B):

SEC. 23 DEDUCTIONS FROM GROSS INCOME

In computing net income there shall be deductions:

* * * * * * *

(1) *Depreciation*—A reasonable allowance for the exhaustion, wear and tear of property used in the trade or business, including a reasonable allowance for obsolescence. . . .

* * * * * * *

(n) *Basis for Depreciation and Depletion*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in Section 114.

* * * * * * *

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[1] Section 113(b)(1)(B) of the Revenue Act of 1936, here involved, is identical with Section 113(b)(1)(B) of the Revenue Act of 1938, involved in the *Virginian Hotel* case, and with the Section 113(b)(1)(B) of the Internal Revenue Code.

SEC. 114 BASIS FOR DEPRECIATION AND DEPLETION

(a) *Basis for Depreciation*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in Section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

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SEC. 113 ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS

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(b) *Adjusted Basis*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

(1.) *General Rule*—Proper adjustment in respect of the property shall in all cases be made—

• • • • • • •

(B) In respect of any period since February 28, 1913, for exhaustion, wear and tear, obsolescence, amortization, and depletion, to the extent allowed (but not less than the amount allowable) under this Act or prior income tax law. . . .

• • • • • • •

Statement

The facts in this case are stipulated (R. 18-22) and were so found by the Tax Court (R. 23-27).

Petitioner is a Georgia corporation engaged in the manufacture of cotton textiles. It filed its income tax returns for the years 1936 and 1937 (fiscal years ended August 31,

1936 and August 31, 1937) with the Collector of Internal Revenue for the District of Georgia, showing net income of $5,926.92 for the year 1936 and a loss of $12,415.74 for 1937. In each of these tax returns, petitioner claimed for depreciation of its property an amount which was questioned by the Commissioner and which is the subject of the present controversy. The percentage rates used by the Commissioner in recomputing the deductions for depreciation are stipulated to be correct. This controversy concerns only the proper method of determining for these taxable years 1936 and 1937, the adjusted basis to which the depreciation rates will be applied.

Section 113(b)(1)(B) of the Revenue Act of 1936 provides that the original basis of property shall be reduced by depreciation previously "allowed (but not less than the amount allowable)". The sole issue in this case is whether the word "allowed" is to be so construed as to require a taxpayer to reduce the basis of his property because of errors made on prior years' returns, which were errors when the returns were filed, where the Government suffered no harm from the errors.

In determining the adjusted basis of petitioner's property for depreciation in the fiscal years 1936 and 1937, the Commissioner deducted from the admittedly correct basis of the property at the beginning of the fiscal year 1928, the amounts of depreciation shown on petitioner's income tax returns for the fiscal years 1928 through 1935—on all of which the statute of limitations on the collection of taxes had expired —thereby proposing a deficiency in tax of $1,610.25 for 1936 and $305.97 for 1937. It is stipulated, however, that the figures shown on these returns for 1928 through 1935 were erroneous in that they were in excess of the correct or "allowable" amounts for each of these years. It is also stipulated that in each of the years 1928 through 1935, there was a net loss and that even if only the correct or "allow-

able" depreciation had been deducted, there would still have been no taxable net income.[2]

Petitioner contended that the basis of its property should not be reduced by these errors which had no effect on taxes. The Tax Court, considering itself bound by this Court's interpretation of the applicable statutory provision in *Virginian Hotel Corp.* v. *Helvering*, 319 U. S. 523 (1943), upheld the Government's contention that the erroneous depreciation shown on the earlier returns had been "allowed". The Court of Appeals for the Fifth Circuit affirmed also on the ground that it was bound by the *Virginian Hotel* decision.

It is important to an understanding of this case to realize that the case does not involve an estimate of useful life of property which was reasonable when made in the light of facts then known but which in the light of later events proved to be an incorrect estimate. Quite the contrary. This case involves the writing on earlier income tax returns of figures for depreciation which were completely in error when written in the light of facts reasonably known to exist at the end of each taxable year. It is so stipulated. Thus the case is just the same as if there had been the slip of a pen by a bookkeeper making out the earlier returns, or the addition by a careless typist of an extra zero to the figure for depreciation which went unnoticed because it had no effect whatsoever on taxes.

Specification of Errors to Be Urged

The Court of Appeals erred:

1. In affirming the decision of the Tax Court that petitioner is subject to deficiency income taxes for the fiscal years ended August 31, 1936, and August 31, 1937.

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[2] Except as to the fiscal year 1933, as to which there would have been $973.51 of taxable income. That amount is not in controversy since Petitioner concedes that the figure for 1933 has been "allowed" to the extent that a tax saving resulted.

2. In concluding from the facts as stipulated that petitioner must subtract from its original basis for allowance of depreciation in the taxable years amounts reported as depreciation in income tax returns for previous years and not challenged by the Commissioner, to the extent that such amounts reported as depreciation for such previous years exceeded the amounts then properly allowable where such amounts did not offset taxable income.

3. In concluding from the facts as stipulated that petitioner was bound in the taxable years in question by errors made in prior years in deducting depreciation in excess of that allowable where the errors have not resulted in any benefit to the taxpayer or loss to the Government.

Reasons for Granting the Writ

Introduction

It is a universal principle in our federal tax system that an error in an earlier year can be corrected in a later tax year provided the error had no effect on taxes. In response to Petitioner's challenge, the Commissioner has named no other example in the whole field of income taxation where such an error can not be corrected. Yet in the present case —where the taxpayer made in his earlier income tax returns some errors which had no tax effect—the Commissioner has insisted that the erroneous figures shown on the earlier returns are binding on the taxpayer in a later tax year.

What reason is given for this extraordinary result? The Commissioner, the Tax Court and the Court of Appeals have given none. Petitioner challenges the Commissioner to advance a single reason based on logic or policy considerations why this result should obtain. In response to taxpayer's demonstration of the unfair and erroneous result sought, the Commissioner and the lower courts have had only one reply

—that the result is required by the *Virginian Hotel* decision of this Court.

Petitioner concedes to this Court—as it has conceded below—that if the statutory interpretation of the word "allowed" in Section 113(b)(1)(B), which was made by this Court in the *Virginian Hotel* case, is followed in this case, Petitioner must lose. That interpretation, we respectfully submit, is wrong and unjust. It should be overruled.

This Court in the *Virginian Hotel* opinion showed no recognition of the problem raised by a case such as this where there was, on an earlier year's return, a genuine error which was an error at the time the return was filed. On the contrary, the opinions show that it is quite possible that the Court in that case was directing its attention to an estimate of useful life of property which was reasonable when made but which later turned out to be incorrect. If the *Virginian Hotel* case did involve the latter situation the *result* of the decision is correct, since the depreciation amounts shown on earlier returns were "allowable"—that is, correct in the light of the facts existing at the end of the earlier years. But if this Court had understood the effect which its interpretation of the word "allowed" would have in a case involving a genuine error made in an earlier return, it would never have promulgated any such interpretation.[3]

I. *Certiorari should be granted here so that this Court may correct its erroneous interpretation of the statute in the Virginian Hotel case.*

(a) *It is questionable whether this Court in the Virginian Hotel case ever considered the problem involved here.*

In the present case it is stipulated (R. 26) that the rates

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[3] Scholars in the field of taxation, seeing the full implications of the *Virginian Hotel* decision, have uniformly criticized the decision. See e. g., 2 Rabkin & Johnson, FEDERAL INCOME, GIFT & ESTATE TAXATION 2837; 1 Montgomery, FEDERAL TAXES: CORPORATIONS & PARTNERSHIPS (1949-50) 301; 56 HARV. L. REV., 1164 (1943). So far as counsel have been

which taxpayer seeks to use for depreciation in the earlier years for the purpose of determining his adjusted basis

> "are agreed to be the rates properly 'allowable' in all of the fiscal years 1928 to 1937 . . ."

This stipulation clearly agrees upon the correct or "allowable" amount of depreciation in each of those earlier years in the light of the facts reasonably known to exist at the end of such year.[4] Thus, if the Commissioner had investigated the returns the day after filing for each of those years, he would have determined that the depreciation figure on the return was erroneous just as surely as if the bookkeeper had put a decimal in the wrong place on the return.[5]

On the other hand, when one turns from the present case to the *Virginian Hotel* case, it is not clear from the opinion

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able to find, not a single secondary writer has stated that the decision is correct. The American Bar Association in 1943 passed a resolution criticizing the decision as incorrect, and asking for retroactive Congressional correction. See 68 A.B.A. REPORTS, pp. 166-167. Congress has not passed any general revenue revision bill since that time.

[4] This is the clear meaning of the word "allowable" when that word is used in the statutory sense. *Commissioner* v. *Mutual Fertilizer Company*, 159 F. 2d 470 (C.C.A. 5th, 1947) (citing relevant Treasury Regulations which have consistently interpreted the statute the same way). Thus, if a depreciation figure is correct when made but simply turns out later to be excessive, the original figure is the correct or "allowable" depreciation. *Id.* That the word "allowable" in the present stipulation was used in the statutory sense is shown not only by the fact that the word was put in quotation marks but also by the fact that the words "*in all of the fiscal years*" immediately followed the word "allowable".

[5] The fact that the particular tax item involved in the earlier year (depreciation) was an item which called for some process of judgment in its determination, does not at all lessen the fact that an error was made. The correct or "allowable" depreciation is a fact susceptible of precise determination, if necessary by litigation. It may also be determined precisely, as in this case, by stipulation. There are many other determinations in the tax field where the same is true. For example, to determine the value of a piece of property requires the exercise of judgment, and yet the concept of value presents an issue of fact susceptible of accurate determination. If the parties can not agree, the taxpayer can get a court to decide to the penny the true value of a piece of property.

of the Court or the dissents that this Court's attention was directed to an incorrect depreciation figure *which was in error at the time the earlier return was filed.* On the contrary, the Court may well have been thinking about the selection of a depreciation figure which was correct when made in the light of the facts reasonably known to exist at the end of the tax year but which, because of later facts, turned out to be inaccurate. Reliance by the Court on the Government's brief in the *Virginian Hotel* case would have produced this result. That brief, for example, stated:

> "The deductions were actually available to it, just like any other deduction *to which it was then entitled,* although it was subsequently found that the amount has been excessive." (Italics added) (Brief for Commissioner, p. 9, *Virginian Hotel Corp.* v. *Helvering,* 319 U. S. 523 (1943).)[6]

Moreover, the record in the *Virginian Hotel* case does not clearly establish that there were genuine errors in the earlier years. The controlling stipulation is ambiguous, and is easily susceptible of meaning merely that the earlier years' estimates were correct when made but were proved by later facts to be inaccurate.[7]

For these reasons Petitioner respectfully suggests that the Court failed to realize the full implications of the *Virginian Hotel* decision in a factual situation such as we

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[6] More complete extracts from the Brief for the Commissioner in the *Virginian Hotel* case to the same effect are printed as Appendix "A" to this Brief.

[7] The *Virginian Hotel* stipulation states:

> "If the depreciation is recomputed for the years prior to the year 1938, using . . . the amount allowable at respondent's rates as determined for 1938 for the years which resulted in a net loss, the results will be: . . ."

It should be noted that the word "allowable" was not put in question marks and not used as a word of art. On the contrary, the words used in this stipulation, when considered in their context, merely mean "figured at the respondent's rates as determined for 1938 for the years which resulted in a net loss."

have here. Therefore it should not hesitate to consider now those implications. Such consideration will make crystal clear the egregious error of the former decision.

(b) *In the Virginian Hotel case this Court rested its decision on an erroneous construction of the word "allowed."*

Prior to the enactment of Section 113(b)(1)(B) in its present form the corresponding statutory provision required the basis of property to be reduced merely by the depreciation "allowable." In 1932 the statute was changed to its present form so as to require the reduction of basis by the depreciation "allowed (but not less than that allowable)." The legislative history shows beyond question that Congress, in making this change, sought only to make it clear that a taxpayer *who had reduced taxes* by deducting excessive depreciation in former years *on which the statute of limitations had run,* must reduce the basis of his property in current years by the excessive deductions thus allowed in the past.[8]

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[8] The Senate Committee Report (S. Rep. No. 665, 72d Cong. 1st Sess., p. 29), which is substantially identical with the House report, states:

> "The Treasury has frequently encountered cases where a taxpayer, who has taken and been allowed depreciation deductions at a certain rate consistently over a period of years, later finds it to his advantage to claim that the allowances so made to him were excessive and that the amounts which were in fact 'allowable' were much less. ***By this time the Government may be barred from collecting the additional taxes which would be due for the prior years*** upon the strength of the taxpayer's present contentions. The Treasury is obliged to rely very largely upon the good faith and judgment of the taxpayer in the determination of the allowances for depreciation, since these are primarily matters of judgment and are governed by facts particularly within the knowledge of the taxpayer, and the Treasury ***should not be penalized*** for having approved the taxpayer's deductions. ***While the committee does not regard the existing law as countenancing any such inequitable results, it believes the new bill should specifically preclude any such possibility.***" (Emphasis added.)

The obvious purpose of Congress was merely to enact a statutory rule of estoppel or quasi-estoppel, in order to make sure that a taxpayer would not gain an inequitable advantage. If the taxpayer has succeeded in reducing his tax liability by an excessive deduction for depreciation in one year, and the Commissioner is later prevented by the statute of limitations or by a final closing agreement (I.R.C. Sec. 3760) from assessing a tax with respect to the excessive charge, then the taxpayer in later years is precluded from correcting the error by restoring the excessive amount to "basis," upon which further depreciation is allowable. That Congress intended simply to enact such a rule of estoppel is made perfectly clear by the explanation of the Congressional committees, quoted in footnote 8, *supra.* The committees refer specifically to the case where the government would be barred from collecting additional tax for the earlier year, and they conclude with the view that even under the then-existing law such inequitable results would not be countenanced. There was no intention to enact any novel rule or to impose a penalty for innocent errors. Unless the taxpayer has gained for an earlier year such an unjustified tax advantage which can not be remedied, the Government has suffered no damage, and there is no basis for applying any kind of estoppel.

This Court, however, in the *Virginian Hotel* case, construed the word "allowed" (added by the 1932 amendment) so as to force a taxpayer to reduce his basis for depreciation by an erroneously high figure even in situations where the error in claiming the excessive depreciation in the earlier year had caused the Government no damage. In its opinion, the Court admits that "under our Federal tax system, there is no machinery for formal allowances of deductions from gross income," but goes on to conclude that depreciation is "allowed" within the meaning of the basis provision if it is written on a return and if the Commissioner

takes no steps to "challenge" it.[9] The Court does not suggest that the application of the principle announced depends, in any way, on whether or not any taxes were saved by the excessive deductions; nor is the application of the principle made to depend on whether the statutory period has expired in which taxes could be collected if any had been due. The Court simply announces as a general rule that if excessive depreciation is claimed on a return and not "challenged" it is "allowed," and basis must be reduced thereby.

Under this interpretation erroneously excessive depreciation shown on a return would be "allowed", if the Commissioner did not "challenge" it, in *all* of the following cases:

1. A year where the taxpayer would have reported additional net income and paid additional taxes if he had deducted only the correct depreciation.

(a) Where the statute of limitations on assessments for that year has expired.

(b) Where the statute of limitations on assessments for that year is still open and the taxpayer seeks to correct his error by filing an amended return.

2. A year where there was a loss and the taxpayer would have reported no taxable income even if he had deducted only the correct depreciation.

(a) Where the statute of limitations on assessments for that year has expired.

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[9] Excessive depreciation figures in loss years such as those here involved will always be unchallenged as a matter of course. Realizing the obvious fact that he has no authority or machinery whatsoever to challenge such figures, the Commissioner has directed Bureau personnel to give no consideration to depreciation if the examining agent is satisfied that there will be a loss for the year in any event. Mimeograph 4170, XV-2CB, 148, 149.

(b) Where the statute of limitations on assessments for that year is still open and the taxpayer seeks to correct his error by filing an amended return.

The Commissioner correctly applies this interpretation to situation 1(a)—a profit year where the statute has run. This is the situation which Section 113(b)(1)(B) is clearly designed to cover, since the taxpayer there has benefited from his error and would get a double deduction if he were permitted to restore the excessive depreciation to basis after the statute had barred the collection of taxes for the year of the deduction. In situation 1(b)—a profit year where the statute is still open—the Commissioner, contrary to this Court's opinion, will allow the correction since he can still assess the additional tax which is due pursuant to the corrected return. The Commissioner will also permit the correction in situation 2(b)—a loss year where the statute is still open—although the correction there does not change tax liability. However, in situation 2(a)—a loss year where the statute has run—he denies the taxpayer's right to correct the error. This denial is patently illogical, unjust, and inconsistent with the Commissioner's recognition of the taxpayer's right to correct his error in a loss year when the statutory period has not expired. It must be admitted, however, in fairness to the Commissioner, that this denial is required by what was apparently this Court's decision in the *Virginian Hotel* case.

Since the Commissioner himself, however, does not apply fully the rule announced but applies it to only one of three situations [9a] to each of which it could with equal (if any) logic be applied, he must realize the absurdity of the rule as a whole. Under such circumstances it is indeed strange that

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[9a] If the rule were sound at all it would with equal logic apply to 1(b), 2(a) and 2(b). The Commissioner applies it only to 2(a).

the Commissioner—instead of coming to this Court and requesting, as he should, that the Court correct its 5 to 4 decision in the *Virginian Hotel* case—continues to support the validity of the rule as it is applied to an erroneous depreciation deduction which *did not* reduce taxes merely because the statute of limitations *would* have barred the collection of taxes *if* any had been due.

Any such rule overlooks the obvious fact that the expiration of the statute of limitations does not harm the Government and, as a matter of fact, is completely meaningless when it relates to a year where the correction of the erroneous depreciation deduction would entail no tax even if the statute of limitations were still open. In attaching any importance to the expiration of the statute of limitations where no taxes would be due in any event, the Commissioner completely overlooks the true significance of the statute of limitations (as does this Court if it accepts the Commissioner's interpretation of its opinion).

The statute of limitations merely imposes a time limitation on the assessment and collection of taxes and upon refunds and credits. There is no statute of limitations against the correction of an erroneous figure in some prior tax return when that same figure affects the amount of tax due in a later open year. With respect to the correction of such an error, the only effect which the statute of limitations could possibly have is that it may operate to render uncorrectible an error *from which the taxpayer has gained a tax advantage* in the earlier year. In this event, the running of the statute of limitations completes an equitable estoppel, and it is fair to conclude that the earlier figure shown for depreciation has been "allowed" within the statute, since it has been *used* against tax liability. This is the very situation that Congress intended to cover. But where the earlier error had no effect on taxes, then the running of the statute of limitations on assessment is a complete nullity. In such

a case, it is ridiculous to assume that Congress merely by using the word "allowed", intended for this otherwise meaningless expiration of time to be given any effect whatsoever under Section 113(b)(1)(B).

(c) *This Court's interpretation of the statute violates the fundamental principle of federal income taxation that an error in a prior tax year can be corrected if it had no effect on taxes.*

From the very early stages in this case, Petitioner has repeatedly challenged the Government to cite any other case in the whole field of income taxation where Congress or the courts have shown any intention to bind a taxpayer in a later tax year by an error made in the return for an earlier tax year where the error resulted in no damage to the Government or benefit to the taxpayer. Whether there are any such examples is important to a proper construction of the word "allowed" in Section 113(b)(1)(B). If there are no other such examples, it is hard to believe that in using the word "allowed" in this statute, Congress intended to impose any such penalty, in this one particular situation where no reason can be suggested for a penalty.

The Government has come forward with no examples in answer to this challenge. It will come forward with none in its brief in opposition to certiorari. The reason is clear. The type of penalty sought to be imposed in this case is unique in the whole history of income taxation.

That the taxpayer can correct errors made in earlier returns with respect to items which affect taxes in a later year can be demonstrated by numerous examples. The following example will suffice to show the extraordinary nature of the result sought by the Government in this case:

Suppose that a taxpayer in 1930 swapped a race horse (as to which property he had a zero basis) for a strip of land

which, at the time of the swap was worth $5,000. In his 1930 tax return, prepared hurriedly, the taxpayer picked a figure at random and showed the land as being worth only $1,000, and, as a result showed a gain of $1,000, whereas he should have shown a gain of $5,000. Assume further that the taxpayer had such heavy losses in 1930 that even if he had shown the $5,000 gain there would have been no tax due by him to the Government. Suppose that in 1940 the taxpayer sold the land for $50,000, which was its correct 1940 value, the increase being due to the discovery of oil on the land. At that time, the taxpayer, realizing that he had made out his 1930 income tax return hurriedly at a time when his heavy losses made the difference in value unimportant, made a careful examination and found that the 1930 value was $5,000. Accordingly, the taxpayer showed on his return in 1940 a gain of $45,000 instead of $49,000. In this case, the Commissioner would never even contend that the taxpayer would be bound by the $1,000 he had shown on his 1930 income tax return, whether or not the statute of limitations had run on the collection of additional taxes for 1930.

The example just given also shows that an earlier error can be corrected, even though that error involved a tax item in the determination of which some process of judgment was required. The fact that the value of the property is in one sense an estimate does not make the error on the 1930 return any the less real than if there had been a slip of the pen by the person making out the return. The important thing is that the error in valuation was an error at the time the 1930 return was filed in the light of the facts then reasonably known to exist.[10] This being true,

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[10] It should be noted in the example given that the *error* in the 1930 return consisted, not in the failure to report a value reflecting the presence of oil, which was then unknown, but in the failure to report the

the error can be corrected later, since it caused the Government no damage.

(d) *Although the result reached in the Virginian Hotel case may possibly be justified on the facts there involved, this Court's interpretation of the word "allowed" renders the lower courts powerless to avoid completely unjustified and inequitable results in cases involving facts like those stipulated here.*

While, as pointed out above, this Court perhaps did not face in the *Virginian Hotel* case the problem involved in the present case, the Court did lay down an interpretation of Section 113(b)(1)(B) which, if applied to the facts of the present case, brings about a completely inequitable and fallacious result. However, no matter how inequitable and no matter how contrary to the true meaning of the statute a lower court might feel such a result to be, the lower court is bound by what this Court has done. This Court's prior decision will render powerless all other courts until the proper interpretation of the statute is reconsidered by this Court. This is an added reason why certiorari should be granted.

(e) *The decision in the Virginian Hotel case is not the kind of decision to which it is important to apply stare decisis.*

Petitioner recognizes the general importance of *stare decisis* in the tax field where it is necessary that taxpayers know the law in order to plan their business activities accordingly. But the policy reasons behind the doctrine of *stare decisis* do not apply to prevent a reconsideration by this Court of what we submit was an error in statutory interpretation in the *Virginian Hotel* case. Since the only

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$5,000 value which was the value of the property in the light of the facts which in 1930 were known to exist.

effect of that decision was to penalize a taxpayer for an error made, no one could have been led in reliance on the decision to take any action the expected results of which would be disrupted by a reconsideration by this Court. In this type of case, especially, the Court should adopt the philosophy of Mr. Justice Frankfurter, dissenting, in *Henslee v. Union Planters Nat. Bank & Trust Co.*:[11]

> "Wisdom too often never comes, and so one ought not to reject it merely because it comes late."

II. *The question involved is of general applicability and of great importance in our tax system.*

(a) *Large numbers of taxpayers are similarly affected by this statute.*

The statute here involved impinges on large numbers of taxpayers. Affected are all taxpayers who have made errors or will make errors in showing on income tax returns excessive figures for depreciation, obsolescence, amortization or depletion where those errors have no effect on taxes. The statute may come into play later when the taxpayer sells the property, or when he has retained the property and seeks to compute correctly for the later years his allowance for depreciation, obsolescence, amortization or depletion. The question then is whether the taxpayer will be bound by his earlier errors which have had no tax effect.

The question is of general applicability because in the cases of all these taxpayers the result will not turn upon factual circumstances peculiar to the particular taxpayer but rather will depend upon the construction of Section 113(b)(1)(B) of the Internal Revenue Code (or identical provisions of prior revenue acts) finally adopted by this Court.

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[11] 335 U. S. 595, 600.

(b) *The fundamental unfairness of the Virginian Hotel decision is harmful to the Government.*

As previously pointed out, it is a universal principle of our tax system that either a taxpayer or the Government can correct errors which have had no tax effect if the items concerning which the errors were made become relevant in later tax years. Any other rule would be obviously unfair. While Congress might in a particular situation deviate from this universal rule, certainly the courts should, in any given case, require clear proof that such a deviation with all its attendant incongruities,[12] was intended. There has been no such proof here.

It is vitally important in our tax system, under which taxes are largely self determined, that the taxpaying public retain a high degree of confidence in the fairness and impartiality of the tax system—the tax laws and their administration. Where the Commissioner of Internal Revenue or a lower court or even this Court wrongly interprets a statute of Congress so as to violate a fundamental principle of fairness (*e.g.*, the right to correct errors), this Court should recognize the very harmful effect of such an obviously unfair rule upon taxpayer-government relations. What could cause a tax system to be held in greater disrespect than to collect high taxes from business, not on the basis of real income, but on the basis of innocent errors on prior returns which have caused the Government no damage?

Thus the importance of this case goes far beyond the $1,916.22 of tax involved in this petition, and beyond whatever taxes are involved for other taxpayers similarly situated. It goes to the whole problem of the relationship between the Government and all its taxpayers in our tax

[12] Examples of incongruities created by the *Virginian Hotel* decision interpretation of the word "allowed" are set forth in Appendix "B" to this petition.

system, which is absolutely dependent for its effectiveness on the voluntary compliance of the taxpaying public.[13]

Conclusion

It is respectfully submitted that the petition for certiorari herein should be granted.

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[13] The importance of carefully guarding taxpayer morale is made evident when it is realized that only a small fraction of all returns can receive more than an office audit to catch mathematical errors. Under these circumstances it is vital that taxpayers have no examples of flagrant mistreatment by the Government which might form a basis for rationalizing understatements of income. As the recent Advisory Group to the Joint Committee on Internal Revenue Taxation said after investigating the Bureau of Internal Revenue:

> "The most economical enforcement program from a long-run viewpoint is one which maximizes the likelihood that the original tax return is completely and correctly filled out. . . . The key to a fuller utilization of the taxpayers' cooperation lies in the adoption of Government policies and practices which will lead to a greater degree of mutual confidence. The responsibility rests with Congress, tax administrative officials, and the courts to initiate and aggressively pursue such policies. . . . There should be no reasonable grounds for taxpayers' rationalizing false returns on the grounds of getting even with the Government or rectifying its mistakes." (*Investigation of the Bureau of Internal Revenue*, Report to the Joint Committee on Internal Revenue Taxation pursuant to Section 1203(b)(6) of the Revenue Act of 1926, by the Advisory Group Appointed Pursuant to Public Law 147, 80th Congress, (1948), pp. 22-23).

APPENDIX "A"

Extracts from Brief for the Commissioner in the Virginian Hotel Case

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The taxpayer, however, would turn the rate reduction to its definite advantage. Except insofar as the statutes have specifically provided for loss carry-overs, the revenue laws do not contemplate that a taxpayer shall be allowed to take advantage in a later year of deductions *available* in earlier years which gave it no tax benefit because of insufficiency of income. Each tax year stands on its own footing. *Burnet* v. *Sanford & Brooks Co.*, 282 U. S. 359. Consistently with the depreciation schedule which had been employed since 1927, with the approval of the Commissioner, the taxpayer continued to take these deductions through its loss years 1931-1936. *The deductions were actually available to it, just like any other deduction to which it was then entitled, although it was subsequently found that the amount had been excessive.*

• • • • • • •

The statutory allowances for depreciation provide a taxpayer an opportunity to recover tax-free his investment in property which is used in producing income and is being consumed or is deteriorating in the process. In taking the deductions, he is required to estimate in advance the anticipated life of the property and is required to spread the deductions over that estimated life. Thus, if he estimates that the property will have a useful life of 20 years, he will each year deduct from income 1/20 of the cost or other basis of the property; accordingly, over the 20 years he is deriving income from the property he will be permitted to take deductions equal to his investment in the property.

Based as it is on beforehand estimates of useful life, the method, of course, cannot be precise and adjustments will sometimes be necessary. *Experience with the property will often show that the useful life of the property has been overestimated or underestimated. When this occurs, a new*

estimate is made, and the basis of the property, to the extent that it has not been recovered by prior deductions, is spread over the remaining life as thus reappraised.[14] This is accomplished under the statute involved here, by reducing the original basis by depreciation previously "allowed," or that "allowable," which ever amount is greater and by applying to this adjusted basis the new rate calculated upon the new estimate of a useful life.

APPENDIX "B"

Examples of Other Incongruities Resulting from the Commissioner's Interpretation of the Word "Allowed"

1

The following example shows how the Government, relying on the Virginian Hotel decision, will correct an erroneous figure for basis shown on a return for a closed year, but will refuse to permit the taxpayer to correct the erroneous figures for depreciation shown on the returns for that and subsequent closed years, although such errors in depreciation are admittedly due to the original error in basis:

A taxpayer received, in a taxable exchange in January, 1940, machinery having a fair market value of $50,000. Taxpayer mistakenly returned it at $100,000. Taxpayer then showed on its returns for 1940, 1941, 1942, 1943 and 1944, depreciation at 10% rate, or $10,000 per year. Assume that in all of these years, taxpayer had such heavy losses that no tax would have been due even if only the correct depreciation had been shown. Assume that the 10 per cent *rate* of depreciation is the correct rate. Therefore the actual depreciation sustained was $5,000 per year.

After the statute of limitations has run on 1944 and earlier years, the Commissioner investigates 1945, a profit year in which taxpayer has deducted depreciation of $10,000,

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[14] No adjustment is made for the depreciation deductions *for the years preceding the reappraisal* which are still open under the statute of limitations. Sample-Durick Co. v. Commissioner, 35 B.T.A. 1186.

and correctly concludes that the property when received was worth only $50,000. In this case, the Commissioner will correct the original basis to $50,000 rather than $100,000, but will rule that the *Virginian Hotel* decision does not permit the correction of the deductions for depreciation. That is, the Commissioner will claim that the property has no basis at all in 1945 and will disallow all depreciation deduction in 1945.

Thus the Commissioner will correct the error insofar as the correction would aid the Government, but will refuse to permit any corrections in favor of the taxpayer.

2

The following example shows how the Government, relying on the Virginian Hotel decision, will deny a taxpayer the right to correct errors in depreciation shown on returns for earlier loss years, even though the Government has collected additional taxes by insisting that the erroneous depreciation figures must be corrected for even earlier profit years:

A taxpayer constructed buildings in 1929. Profits were made in 1929, 1930 and 1931. Heavy losses were sustained in 1932, 1933, 1934 and 1935. The same depreciation was shown in the returns for all years. In a conference in 1936 covering the years 1929 to 1931 it was agreed between the taxpayer and the Commissioner that the rate of depreciation had been and was excessive, and accordingly the taxes due by the taxpayer for 1929, 1930 and 1931 were increased because of the correction of the error in the depreciation claimed. The taxpayer, immediately after the conference, made out his 1936 return, showing depreciation in all the prior years at the rate just agreed upon in the conference. He did not file amended returns for the years 1932 through 1935 because those were loss year anyway. However, in 1940, when the Commissioner is checking the 1936 return, he refuses to permit the taxpayer to use what both of them have agreed are correct figures for the years 1932 through 1935. He forces the taxpayer to reduce his basis by the erroneous amounts previously shown, on the ground that those amounts have been "allowed" and the errors cannot be corrected. Thus

the Commissioner will insist that the basis of the property reflect the erroneous depreciation shown on the returns during the loss years, even though the Commissioner has already collected additional taxes by correcting the error in the preceding profit years.

3

The following example shows how the Government applies the Virginian Hotel decision, with patent unfairness, to tax years which involve net operating loss carry-overs:

In a taxable exchange on January 1, 1940 X Corporation gets machinery which has a stated value in the contract of $100,000. It puts it on its books and tax return at that figure. The machinery actually had a value in 1940 of $37,000, but there was a large loss in 1940, so that the overstatement of value was of no importance.

In 1940, 1941, 1942, 1943 and 1944 X Corporation deducted on its books and tax returns $10,000 depreciation per year, based on the correct rate of 10% and the incorrect value of $100,000.

Without deducting any depreciation on this machinery, the correct gross income and the correct deductions for each of the years 1941 through 1944 would balance, so that there would be no income and no loss. With the deduction of $10,000 per year depreciation on machinery, there would be a net operating loss for each of the years 1941, 1942, 1943 and 1944 of $10,000 per year.

In 1945 there is gross income of $50,000 before deducting any depreciation on machinery or any loss carry-over. The corporation deducts $10,000 depreciation on machinery for 1945 and brings forward from 1943 and 1944 losses of $10,000 each. This deduction of $30,000 leaves net income of $20,000, which the taxpayer reports on its return.

The Commissioner, we shall assume, makes merely a casual check of the returns for 1940-1944 and leaves them unchanged. (Frequently, of course, he would not even look at them.) Then after the statute of limitations has run on all years through 1944, the Commissioner investigates the profit year 1945 and finds the return for that year correct in all respects except the 1945 depreciation and the net loss

carry-overs from 1943 and 1944. As to those what will he do?

He correctly finds that the value of the machinery at the time it was received on January 1, 1940 was $37,000—not $100,000. In order properly to compute income for 1945, the Commissioner corrects the $100,000 figure (original basis) to $37,000, as he is clearly entitled to do.

The corporation, recognizing the correctness of the adjustment, suggests that depreciation over the 10-year life of the machine be reduced for 1940 and subsequent years to $3,700 per year. But the Commissioner, relying on *Virginian Hotel* for his conclusion, states that this cannot be done in years on which the statute of limitations has run.

The taxpayer then naturally assumes that, since the erroneous depreciation deductions in barred years are to be considered as binding or "allowed", they will exhaust his basis ($37,000) and deprive him of any depreciation deduction in 1945. But he figures he can bring forward to 1945 his losses of $10,000 for each year 1943 and 1944—giving him total operating loss carry-overs of $20,000.

The Commissioner now denies that the depreciation is finally settled for past years. He claims the right to correct depreciation for 1943 and 1944, notwithstanding the fact that the statute of limitations has run on those years. He does this despite the fact that he uses the running of the statute of limitations for 1940, 1941 and 1942 as an excuse for not correcting the depreciation in those years. So here is what he does.

He corrects the basis of the property received in 1940 from $100,000 to $37,000. He deducts the incorrect depreciation for 1940, 1941 and 1942 of $10,000 per year, giving as his reasons the fact that the statute of limitations has run for those years and that the excessive amounts of depreciation were claimed on the returns and not disallowed by the Commissioner. Then when he comes to 1943 and 1944 he says, in spite of the fact that the statute of limitations has run for collection of additional taxes for those years, that the depreciation deductions for 1943 and 1944 will affect income for 1945 (which is not barred) by reason of the net loss carry-over. He therefore deducts depreciation of $30,000 (the depreciation claimed on the returns for 1940,

1941 and 1942) from the basis of $37,000 and finds that at the beginning of 1943 only $7,000 of the basis remains. Since the property has a remaining life of 7 years the proper depreciation on the remaining value is $1,000 per year. So the Commissioner shows a net loss for 1943 and 1944 of $1,000 per year or $2,000. He allows depreciation of $1,000 in 1945. The Commissioner therefore concludes that the taxable income for 1945 is $47,000 ($50,000 minus $3,000) instead of $20,000 as reported.[15]

This example shows the absurdity of any argument, based on administrative difficulty or the statute of limitations, for not going back and correcting the admitted errors as to depreciation. In the example given, the Commissioner has straddled the years 1940-1942 and has not hesitated to correct whatever it is to his benefit to correct, including basis in 1940 and depreciation in 1943 and 1944, although the statute of limitations has run on all these years.

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[15] The only sensible way to report the income would be as follows:

1. Correct original basis to $37,000 as the Commissioner has done.
2. Correct the depreciation deduction for all the barred years from $10,000 to correct amount of $3,700 per year.
3. The depreciation deduction for 1940, 1941 and 1942 would be $11,100. The basis remaining at 1943 would be $25,900 which spread over the 7-year remaining life would be $3,700 per year, which would give losses of $7,400 to be carried forward from 1943 and 1944 to 1945, as a deduction in 1945.
4. In addition, depreciation of $3,700 should be allowed for 1945.
5. The correct income for the year 1945, therefore, is $38,900 ($50,000 minus $11,100).